BEFORE THE

POSTAL RATE COMMISSION

Docket No. R2000-1

POSTAL RATE AND FEE CHANGES, 2000

BRIEF OF THE DIRECT MARKETING ASSOCIATION, INC.

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Dated: September 13, 2000

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

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POSTAL RATE AND FEE CHANGES, 2000	)	**Docket No. R2000-1**

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INTRODUCTION

The Direct Marketing Association, Inc. ("The DMA") respectfully submits this brief, which sets forth The DMA's views on several significant issues in this proceeding: (1) the appropriate allocation, based on the application of the statutory pricing factors to the evidence of record in this proceeding, of institutional costs to Standard (A) commercial mail; (2) the proposal to maintain the rate for single-piece First Class letters ("SPFC") at 33 cents; and (3) the proposal to maintain the SPFC rate "stable" through two omnibus rate cases.

I. THE RECORD CANNOT SUPPORT AN INSTITUTIONAL COST BURDEN FOR STANDARD (A) COMMERCIAL MAIL HIGHER THAN PROPOSED BY THE POSTAL SERVICE.

Witness Mayes has proposed a cost coverage of 132.9% for Standard (A) Regular Mail and 208.8% for Standard (A) ECR. USPS-T-32 at 35, 38. These proposals are based on an analysis of a substantial amount of evidence relevant to the statutory pricing criteria of § 3622(b) of the Postal Reorganization Act of 1970 (the "Act"). Although they entail price increases substantially in excess of those proposed for First Class, The DMA does not take the position that these proposed cost coverages are excessive. However, the Standard (A) cost coverages proposed by the Postal Service are the very highest that can be justified. The Commission should reject any attempts to increase them. On the contrary, the Commission should make

every effort to mitigate the very large (especially in comparison to First Class) price increases being proposed for Standard (A).

Because First Class mail and Standard (A) mail account for a substantial majority of postal revenues, one of the most important pricing decisions to be made by the Commission is the relationship between the institutional cost contributions made by these two classes. Based on the application of the statutory pricing criteria to the evidence of record in this case, the DMA has come to the conclusion that the USPS-proposed cost coverages for the Standard (A) commercial subclasses -- especially as compared to the First Class subclasses -- are reasonable and allocate an appropriate share of the institutional cost burden to Standard (A).[1] The DMA notes, however, that each of the relevant criteria supports giving First Class Mail a substantially higher cost coverage than Standard (A).[2] Therefore, the record also supports decreasing the USPS-proposed Standard (A) cost coverages relative to First Class.

A. Value of Service

The value of service accorded to a class of mail (Criterion 2) is determined primarily by measuring its long-run own-price demand elasticity. Witness Mayes, with the support of calculations by witnesses Tolley and Musgrave, testified that the demand for First Class mail is approximately two or three times less sensitive to price increases than the demand for Standard (A) mail. USPS-T-32 at 6. Moreover, First Class mail receives a wider range of services, which give it a higher intrinsic value of service. These services include: (1) travel by

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[1] The USPS proposes a cost coverage of 194% for First Class Letters. USPS-T-32 at 20.

[2] Witnesses Callow and Clifton, who contend that Standard (A) cost coverages are "unfairly" low compared to First Class Mail, focus only on the first of the nine statutory criteria. They do not contest the evidence amassed in this record, nor do they contend that the cost coverage proposals are inappropriate when evaluated against the other statutory pricing criteria.

air for trips involving considerable distance; (2) an extensive collection system; (3) high priority of delivery; and (4) free forwarding. In all of these respects, Standard (A) lags well behind First Class. For example, Witness Haldi explains that Standard (A) "has a delivery standard that ranges between 2-10 days," whereas "the delivery standard for First Class Mail ranges from overnight to three days." Tr. 44/18853. Thus, this statutory criterion supports a substantially higher cost coverage for First Class as compared to Standard (A).

Witness Clifton contends erroneously that the significant gap between the demand elasticities of First Class and Standard (A) mail should be irrelevant to the pricing decision because both classes have elasticities less than -1.0 and are therefore "price inelastic." Tr. 26/12702. This approach is not consistent with the approach taken by mainstream economists and has not been used by the Commission in prior proceedings. Differences in elasticity matter. They provide an objective measure of the relative value of service accorded each mail class and the ability of each class to bear price increases. Thus, Clifton's suggestion that this pricing criteria be ignored is without merit.[3]

B. Effect Of Price Increases

Criterion 4 requires the Commission to consider the impact of the proposed rates, including the relative size of the proposed rate increases. As witness Mayes points out, the proposed rate increase of 3.5% for First Class mail is one of the lowest increases proposed in R2000-1 and follows a below-average rate increase for First Class (1.7%) in R97-1. USPS-T-32 at 21. By contrast, the Postal Service has proposed a 9.4% increase for Standard (A) Regular and

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[3] Moreover, as Witness Haldi points out, Clifton does not explore the possibility of shifting the "unfair" burden on First Class workshared mail to First Class single-piece mail. Tr. 44/18867. This is particularly odd given that Standard (A) mail, whose rates Clifton does want to increase, is in a highly analogous position to First Class workshared mail.

a 4.9% increase for Standard (A) ECR. USPS-T-32 at 36, 38. Criterion 4, therefore, indicates that the Commission should make a serious attempt to reduce the Standard (A) rate increase relative to First Class. The Standard (A) cost coverage certainly should not be any higher than as proposed by the Postal Service.

C. Available Alternatives

Criterion 5 requires an examination of the available alternatives to a particular class of mail service. The more alternatives are available, the more sensitive consumers will be towards price increases in that particular mail class. With respect to this factor, it is patent that First Class has fewer alternatives than Standard (A) mail. Although email and other forms of electronic correspondence have emerged as viable options for some First Class users, those are the only reasonable substitutes for First Class mail and remain quite limited for most consumers. USPS-T-32 at 21. Standard (A) mail, by contrast, faces stiff competition for advertising dollars from the Internet as well as from traditional media like newspapers, magazines, radio, and television. *See* USPS-T-32 at 36. Thus, Standard (A) is much less capable of supporting a high cost coverage than First Class Mail.

II. THE REASONS ADDUCED FOR MAINTAINING A 33-CENT SPFC RATE LACK MERIT.

The arguments raised in favor of maintaining the SPFC rate at 33 cents are deeply flawed. These arguments, made primarily by OCA Witness Callow and ABA & NAPM Witness Clifton, purport to draw conclusions from trends calculated over the past 10 years. These presentations share the fatal flaw that they are not based on the application of statutorily mandated pricing factors to the evidence of record in this proceeding. Importantly, these witnesses do not argue that the Postal Service's analysis of these factors is erroneous.

These witnesses also share the rhetorical device of proclaiming loudly and often that the First Class rates are "unfair" and "discriminatory," not to mention "inequitable" and "out of hand." *See, e.g.*, Tr. 26/12458. Under applicable law, however, mere rhetoric cannot substitute for a careful analysis of the evidence.

The centerpiece of OCA witness Callow's testimony is a series of calculations resulting in what he claims are the average "benchmarks" that the Commission "intended" with respect to the relative cost coverages of First Class and Standard (A) mail.[4] Witness Callow then proceeds to argue that First Class has made "excess" contributions to institutional costs over the 1990s. Tr. 22/10121. Based on his calculations, witness Callow argues that First Class letter mail has contributed net additional revenues to the Postal Service in the amount of $6.8 billion. Tr. 22/10120. Relying on this number, Callow argues that the Commission should, in this case, "mitigate" the institutional cost burden of First Class mail on the ground of "simple fairness," stating that maintaining a 33-cent First Class stamp "would enhance fairness and equity." Tr. 22/10125. Witness Callow further states that "the trend of a higher institutional cost coverage . . . . in excess of that intended by the PRC requires mitigation." Tr. 22/10126.

Witness Callow's argument is fraught with misstatements and legal insufficiencies. For example, it is wholly erroneous to state that the Commission "intended" any result concerning average rates over the past decade, or any other period for that matter. The Commission's intentions were specifically stated in each of its opinions and, as is required, related solely to the evidence of record in each respective proceeding. In short, witness Callow's

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[4] Witness Callow calculates that the "intended" average First Class Letters mark-up index benchmark is 1.263.

average index benchmark is a mere figment of his creative mathematical imagination, and is just as useful.

Second, Callow argues that a 33-cent First Class stamp is appropriate in this procceding because it was "lawful" when recommended in Docket No. R97-1. Tr. 22/10177. He totally misses the point. Whether a 33-cent First Class stamp was lawful based on the record in R97-1 is totally irrelevant to the question, being actively litigated in this case, whether a 33-cent stamp remains lawful given the record in this proceeding. It is the record in this case, not the record in R97-1, that controls the lawfulness of the rates to be recommended by the Commission here.

Finally, witness Callow has totally failed to engage in the required analysis of the nine statutory pricing factors in making his 33-three cent proposal. He does, of course, state his conclusion that the USPS-proposed rate structure is "unfair," but this assertion does not amount to a demonstration that the proposed rates are unreasonably discriminatory, which is the essential element of a determination of "unfairness."

Witness Clifton engages in a similar analysis, but without computing an average, decade-long index. Clifton simply notes a trend of relative increases in First Class cost coverage, proclaiming that recent First Class cost coverages have been significantly higher than system-wide cost coverage. Clifton then harkens back to the Commission's opinion in R90-1, where the Commission stated a goal of keeping the First Class cost coverage near the system-wide average.[5] Clifton then proceeds to protest that the USPS proposals are "UNFAIR!" This

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[5] Op. R90-1 at IV-8, ¶ 4022; Tr. 26/12643. Clifton's claim that "a stated goal of the Commission in recent cases has been to keep the First Class cost coverage close to the average for all mail" is totally inaccurate. The most recent case in which the Commission stated such a goal is a decade old. Its recent decisions have reached significantly different conclusions.

assertion is, however, totally unsupported,[6] and the frequency of its repetition does not endow it with added strength.[7] It is also particularly ironic since, as Witness Haldi points out, Standard (A) is probably already in the position of cross-subsidizing First Class Mail. *See* Tr. 44/18867.

Whatever the Commission may have stated in the past concerning its "goals" for the relative institutional burdens borne by First Class and Standard (A)[8] has no continued relevance this case.

First, goals are merely concepts rather than "substantial evidence" upon which the Commission can lawfully rely to support its decision in this case. *See, e.g., Mail Order Ass'n v. U.S.P.S.*, 2 F.3d 408, 420-22 (D.C. Cir. 1993). It is also important that the prior Commission opinions stating the conclusion that the cost coverages for Standard (A) and First Class should be "close to system-wide coverage" do not support this conclusion with a discussion of the statutory pricing factors. Each such opinion simply refers to "history" and asserts the principle in conclusory terms. The only reference to the pricing factors that the Commission has ever made to support this conclusion was its comment in R90-1 about the need to take "care" to "avoid unfairly penalizing First Class Mail, which is the basic means of written personal and business communications in this country, yet is subject to a statutory monopoly."[9] As the Commission

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6 For more on the lack of depth with which Dr. Clifton considered the issue, *see* Tr. 26/12657.

7 Moreover, as Commissioner Gleiman pointed out in questioning Clifton, First Class mail carries approximately the same overall institutional cost burden now as it did in 1990. Tr. 26/12747.

8 *See, e.g.*, Op. R94-1 at ¶ 4049 (p. IV-18); Op. R90-1 at ¶¶ 4021-22 (pp. IV-7 to 8); Op. R87-1 at ¶ 4026 (p. 367).

9 *See* Op. R90-1 at ¶ 4021 (pp. IV-7 to 8).

also noted, however, that monopoly applies to Standard (A) as well. Op. R90-1 at ¶ 4022 (p. IV-8).

Moreover, even Clifton acknowledges that since R90-1 there have been significant changes in the circumstances underlying Postal pricing decisions. Tr. 26/12663. For example: (1) the statutory monopoly over First Class mail has steadily eroded due to alternative forms of electronic correspondence such as the Internet; and (2) classification changes were implemented in MC95-1. Tr. 26/12666-67. The Commission has frequently emphasized that its pricing judgments are appropriately based on judgments reached in prior cases only where there have been no material changes in circumstances. Op. R90-1 at ¶ 4058 (p. IV-19). Since that is not the case with respect to the statements made about Standard (A) and First Class cost coverages in R90-1, those statements are of no relevance in the current proceeding.[10]

The fatal weakness shared by witness Callow and Clifton is that they fail to base their positions on the evidence of record in this proceeding relevant to the statutory mandated pricing factors. They fail to address, for example, the relative size of the proposed rate increases, a factor extremely pertinent under Criterion 4. They fail to consider the acknowledged problems underlying some of the important cost calculations, including those relating to processing of flats, particularly relevant under Criterion 3. They fail to consider the effect that capital investment decisions have on USPS cost incurrence, which is relevant to Criterion 3. Finally, they fail to consider relative service standards, relative intrinsic value of service, and relative sensitivity to price increases, all of which are relevant under Criterion 2.

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[10] Clifton's only response to this critical point is that the Commission has never expressly repudiated its statements in R90-1 about Standard (A) and First Class cost coverages. *See* Tr. 26/12664. As stated above, however, such an express statement is unnecessary given the (continued...)

For the foregoing reasons, The DMA urges the Commission to reject the positions of the OCA and ABA&NAPM that would increase the relative cost contribution of Standard (A) mail.

III. THE OCA'S "RATE STABILITY" PROPOSAL IS UNWORKABLE AND PROBABLY UNLAWFUL.

While certainly creative, the OCA's "rate stability" proposal entails numerous legal and practical difficulties and should not be recommended by the Commission.

The OCA has proposed that the SPFC rate be held stable over two rate proceedings by: (1) implementing an SPFC rate in one case ("Case No. 1") that would be higher than the Commission would otherwise calculate (the "calculated rate"); (2) keeping track of the "excess" revenues in a special "Reserve Account"; and (3) using the amounts in the Reserve Account to offset revenue losses when the same SPFC rate is implemented in the succeeding omnibus rate case ("Case No. 2"). The OCA purports to find several benefits in this proposal, principally: (a) benefiting the consumer through SPFC rate stability over a period anticipated to be four years long, and (b) basing the rest of the First Class rate structure on an SPFC rate freed from the integer constraint. The rate stability proposal would also permit the non-SPFC rates to increase in smaller, more frequent steps, a result that is purportedly favored by business mailers.

Even if the Commission finds that each of these purported benefits is valid, the Commission should not recommend the rate stability proposal, because it has numerous legal and practical flaws.

Commission's clear intent not to rely on past opinions when material circumstances have substantially changed.

A. The Proposal Is Unworkable.

From a practical point of view, the OCA's rate stability proposal will not accomplish the desired goals and will create major distortions in the First Class rate structure.

1. It Is Doubtful That The Reserve Account Will Accrue Sufficient Revenues To Permit The SPFC Rate To Remain Unchanged In Case No. 2.

At the core of the OCA's proposal is the establishment of a reserve account in which the "excess" revenues from the Case No. 1 rates would be accumulated. However, this reserve account would not be a segregated trust or similar fund into which financial assets would be deposited; it would be a mere accounting convention. Thus, the "excess" revenue would continue to be accrued when earned, and there would not be an actual shift of USPS revenues from the earlier period to the later period.

Moreover, the notion that the amount of the (so-called) "excess" revenue accrued under Case No. 1 rates would be adequate to offset the (very real) revenue shortfall under Case No. 2 rates is highly speculative. The OCA's illustration, Tr. 22/10138, conveniently assumes a large differential between the actual SPFC rate and the "calculated" rate, producing a positive balance in the reserve account large enough to offset the revenues needed in the last two years of the analysis. A more realistic assumption concerning the Case No. 1 "calculated" rate would not produce sufficient off-setting revenues, thereby raising serious questions as to what SPFC rate the Commission should recommend in Case No. 2. Thus, witness Gerarden's assertion that the rates stability proposal "would permit the rate to remain unchanged during the second rate case," Tr. 29/13571, is highly suspect.[11]

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[11] Admittedly, the OCA has addressed this possibility and has provided a conceptual "safety valve" in an attempt to deal with situations such as this. The problem, of course, is that the (continued...)

2. The Proposal Would Affect Primarily Business Mailers.

The rate stability proposal is based upon the premise that household mailers would be willing to pay somewhat higher SPFC rates in an initial two-year period in exchange for paying somewhat lower SPFC rates in a subsequent period, with the added "convenience" that they would not have to deal with a rate change in the middle of these four years. However, the SPFC rate would be identical for all types of mailers, Tr. 22/10182, raising serious questions as to the validity of the statement that the proposals would maintain the integer rate "for households." Tr. 22/10134. As OCA witness Callow acknowledges, the vast majority of the mailers affected by the rate stability proposal would be business mailers.[12]

It is not at all clear whether the mailers who would be primarily affected by the rate stability proposal, *i.e.*, business mailers, would share the view that they should pay higher rates in the early years in exchange for the OCA's proposed "rate stability," which they might easily view as contrary to their business interests as well as overly speculative.

3. The Proposal Would Distort Workshare Incentives.

Under the OCA proposal, the rest of the First Class rate structure would be based upon the "calculated" SPFC rate. The OCA asserts that, because this calculated rate would be freed from the integer constraints, work sharing discounts could be based more closely on actual cost differences. The OCA ignores the critical fact that the actual First Class rate structure would reflect substantial distortions from this theoretical construct. Mailers, in fact, would have

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"safety valve" would entail postponing the implementation of rate stability for a period long enough to permit the reserve account to be built up to an adequate level. The very need for a "safety valve" constitutes an admission by the OCA that its proposal may very easily not work in the manner intended.

[12] OCA witness Callow estimates that less than 15 percent of the "excess" revenue would come from household mailers. Tr. 22/10181.

a choice between mailing at the (whole-cent) SPFC rate or at workshare rates based on cost differences from a (non-whole-cent) "calculated" SPFC rate. Thus, the "real world" rates from which mailers would be choosing would, by definition, not reflect "real world" cost differences. These distortions would create artificially high workshare incentives under Case No. 1 rates and artificially low workshare incentives under Case No. 2 rates.

During all four years, uneconomic choices would be made by mailers because they would not be based upon actual USPS cost differentials.

B. The Proposal Is Legally Flawed.

Contrary the OCA's claims, Tr. 29/13571, the rate stability proposal entails significant legal problems, and it is doubtful that the Commission has the authority to recommend it.

OCA witness Gerarden alleges that the proposal would "safeguard" the prerogatives of the Postal Service and the rights of all participants in postal rate cases." *Id.* This statement is conclusory and unsupported by any analysis of several difficult questions. These questions include the following:

1. How can the prerogatives of Postal Service management be maintained, when the SPFC rate in Case No. 2 would be seriously constrained? If the proposal means anything, it would predetermine this rate, thereby significantly tying the hands of the Postal Service concerning the rate that is the single most important feature of the entire USPS rate structure.

2. Does the Act permit the recommendation of rates that would "break even" over two cases, a period estimated to be four years in length? The break-even requirement of Section 3621 has been interpreted for the past thirty years as requiring an analysis of USPS revenues and costs in a single test year. Although the statute does not contain an explicit "one-

year Test Year" requirement, it is hard to see how the requirements of section 3621 can be met without, at a minimum, a full analysis of the entire four-year period during which the rates in question are estimated to be in effect. *See* Tr. 22/10250-51, 10257. At a minimum, therefore, it would seem that the OCA proposal would require major increases in the evidence that the Commission and all parties would need to analyze in any given case.

3. Would SPFC mailers be able to appeal the Case No. 1 SPFC rate on the grounds that the rates would be estimated to produce excess revenues in the Test Year? In the OCA's illustration, Tr. 22/10138, this "excess" amounts to more than $500 million. Would mailers agree that they should pay this excess in exchange for a vague commitment to maintain "rate stability" in the future?

The OCA's presentation is deficient in that it does not address, much less address adequately, these and other important legal questions. These legal deficiencies alone are sufficient to cause the Commission to reject the OCA proposal.

C. The Proposal Is A Fall-Back To The OCA's 33-Cent SPFC Proposal.

Although he does not admit it explicitly, the OCA is proposing the "rate stability" proposal as a fall-back alternative to his main argument, *i.e.*, that the 33-cent SPFC rate should be maintained in this case. Witness Callow's illustration assumes that the SPFC rate will be 34 cents, *id.*, and he states explicitly that "if the Commission maintains the current First Class rate at thirty-three cent, . . . I would not expect the Commission to recommend my rate stability proposal in this proceeding." Tr. 22/10183; *see id.* at 22/10246.

In an important sense, therefore, the OCA is making his "rate stability" proposal in the form of a "second prize." In other words, he seems to be saying, "what I really want is the 33-cent SPFC rate to be maintained in this case, but if I can't get that, I want to lay the foundation for rate stability in the next case."

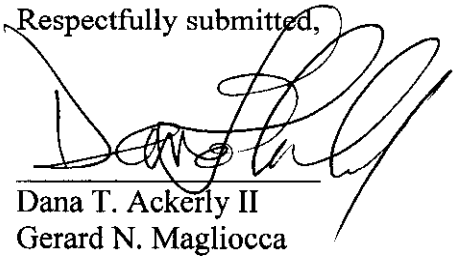
The DMA respectfully submits that this type of argument is inappropriate and inconsistent with the Act. The OCA is arguing for rate stability in this case without the rate stability proposal having been adopted in R97-1. Part of his argument is that First Class mail has been making "excess" contributions to institutional costs over the past decade. If the Commission had established a "reserve account" in R97-1 of the type that the OCA is proposed, it would have succeeded in doing nothing more than giving opponents of the USPS-proposed rates an additional argument to use in the Court of Appeals, *i.e.* a quantification of the extent to which the USPS-proposed SPFC rate was excessive.

For all of the above reasons, the Commission should reject the OCA's "rate stability" proposal.

CONCLUSION

As discussed above, the Commission should (1) approve Standard (A) institutional cost burdens no greater than as proposed by the Postal Service; (2) approve a 34-cent SPFC rate as proposed by the Postal Service; and (3) reject the OCA's "rate stability" proposal.

Respectfully submitted,



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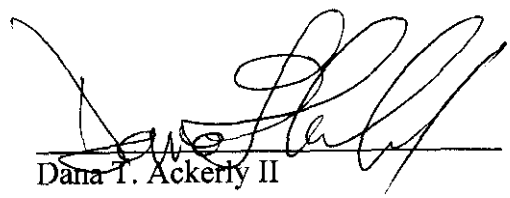
CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document in accordance with the Commission's Rules of Practice.



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